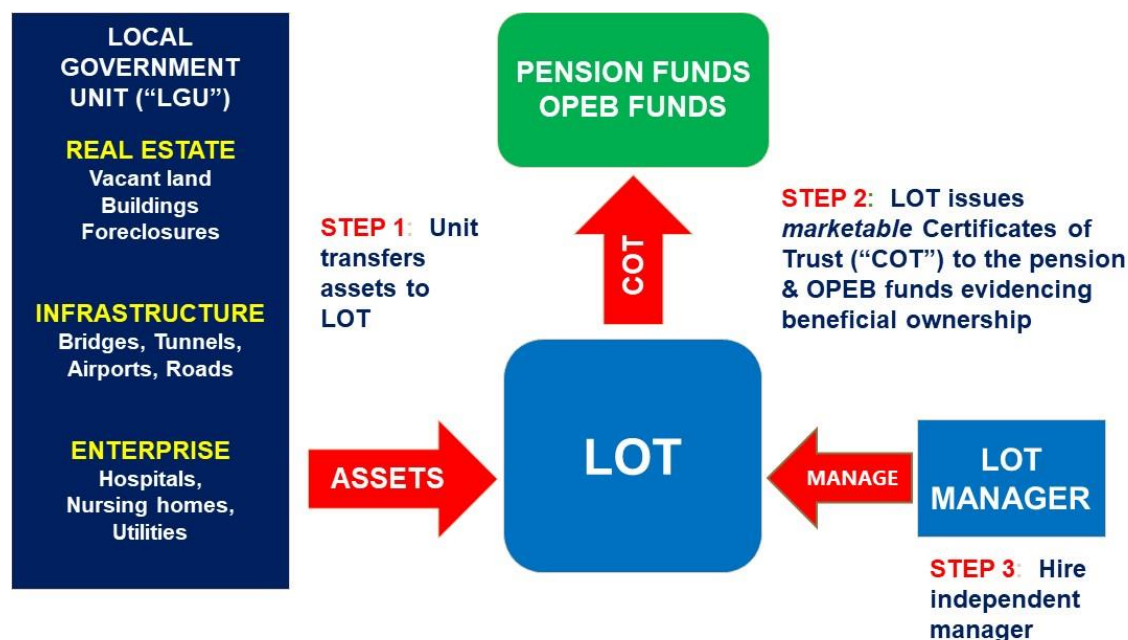


## OVERVIEW

The **Legacy Obligation Trust (“LOT”)** design is where a government makes an in-kind contribution of real assets – like land, buildings, infrastructure, enterprises - to a professionally managed trust for the benefit of one or more underfunded municipal pensions. The trust issues Certificates of Trust (“COTs”), much like shares of stock, and divides them among the various pension funds the government unit sponsors. The COTs convey the fair market value of the assets to the pension funds.

To maximize economic utility of trust assets, which will in turn, increase the fair market value of the COTs, the independent LOT manager could be awarded a limited share of COTs to align a powerful profit incentive with the recovery of stakeholders and the State. The LOT manager can explore various alternatives including a sale, lease, or other strategic partnerships and joint ventures with the private sector and / or existing stakeholders. Driving economic value of the assets contributed to the trust further offsets the legacy obligations.



There are five basic steps to the establishment and functioning of the Legacy Obligation Trust construct.

**STEP 1 – Asset Evaluation:** The first task of the asset evaluation process is where a government unit takes inventory of all of its capital assets, including real estate, infrastructure, and enterprises. An underlying premise is that government assets often hold unrealized equity value

that, if managed for profit, could be unlocked to increase actual value and drive economic growth.

The universe of government-owned assets can generally be divided into two broad categories: (a) developed enterprise assets and (b) undeveloped assets:

- **DEVELOPED ENTERPRISE ASSETS:** State-owned enterprises, authorities, utilities, and other cash generating assets offer immediate value and a dedicated cash stream to support the legacy obligations. Additional value may be realized if these assets are managed more efficiently but the upside may be more limited. The disadvantage of contributing such assets is that the related cashflows already have a constituency that will be deprived of that benefit. Other sources of funding would be required for that constituency to remain unimpaired.
- **UNDEVELOPED ASSETS:** raw land and government occupied buildings can be assessed for their potential to be repurposed for a higher and better use. To the extent that their present utility can be substituted or eliminated, such assets can be developed to generate cashflows, unlocking value that will offset legacy obligations and afford budget relief. Examples might include:
  - raw land to be developed into alternative commercial use like retail, residential, or even alternative energy production like solar farms
  - State offices are consolidated to empty entire buildings that could be leased or sold to the private sector

The advantage of undeveloped assets is that they hold great upside potential and can generate an economic multiplier effect. The disadvantage of such assets that they require professional management and the benefit of time to unlock the higher and better use value. To the extent that contributed assets exist in the government's designated Opportunity Zones, such assets' investment attractiveness is enhanced.

The fair market value of the in-kind contributed assets provide immediate credit to the pension and OPEB funds.

The second task is to establish criteria for asset-selection. The criteria evaluation should consider whether the government could part with an asset either by virtue of its surplus status or by a re-prioritization of public policy.

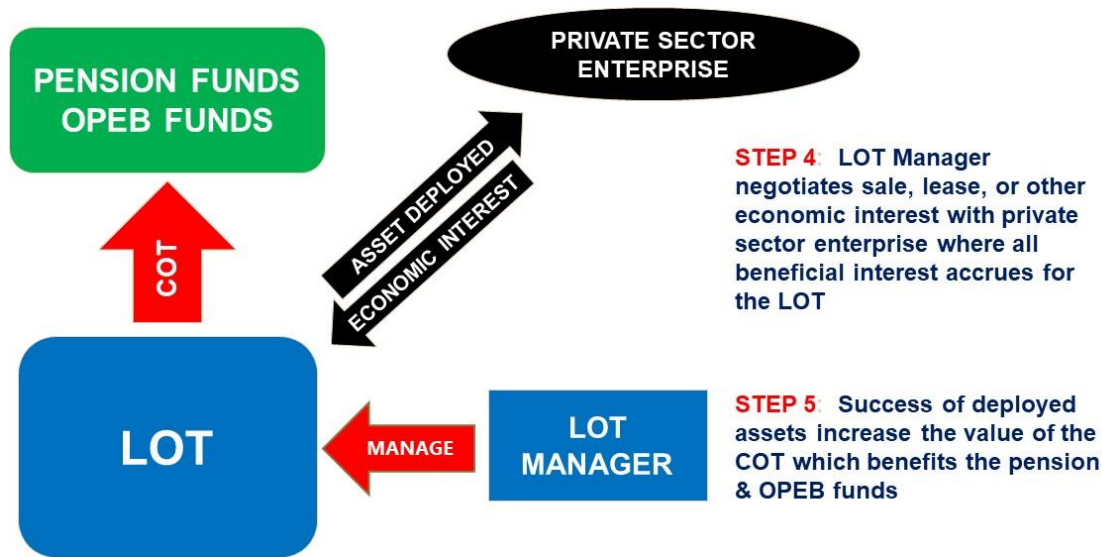
**STEP 2 – Certificates of Trust:** The LOT issues Certificates of Trust to the government unit's pension fund(s); the LOT could issue, say, 100,000 certificates – much like shares of stock. The large number of issues COTs accommodates a division of ownership between multiple pension and OPEB funds. The COTs' value is based on the desk-top valuation of the assets at time of contribution and annually thereafter.

The COTs could be structured as marketable securities. Over time, as the LOT assets generate steady cash dividends, the COTs may become an attractive investment opportunity for third-party money managers. Such a secondary market gives the pension & OPEB funds a liquidation option without forcing the sale of the assets from the LOT. A reliable secondary market for COTs eliminates the need for an annual desk-top valuation. Ultimately, the COT market price becomes a proxy measure of the economic fortunes of the government that has contributed the assets.

**STEP 3: LOT Manager:** Critical to the success of unlocking the hidden equity value in contributed assets is the on-going management of the assets. The selection of the LOT Manager is a consequential exercise for the pension retirees. The skill set of the LOT Manager must be matched to the majority of assets that are contributed. A large firm, with a deep professional bench, might be best suited to the long-term nature of the management effort. Realistically, there is no single firm that could bring the breadth of expertise to manage all assets; the LOT Manager should be enabled to sub-contract the necessary expertise to manage specialized assets but still take responsibility for performance.

The governing charter for controlling the LOT Manager is a subject that requires further development. Ideally, the LOT Manager should be able to function independently of government control or influence – or as much as politically feasible. Independence and minimization of government interference is presumed to enhance the ease of repurposing contributed assets to higher and better utility. In addition, the level of manager independence will have a direct impact on the accounting treatment of the LOT, as more fully explained later in

**Section X.**



**STEPS 4 & 5: LOT Manager Authority & Empowerment:** The LOT Manager should be authorized and empowered to sell, lease, or contribute the assets to joint ventures with the private sector. New money invested in the LOT has the potential to enhance asset value, create new jobs and drive COT valuation that benefit the creditors and pension plans.

The range of the LOT Manager's authority must be memorialized in a management contract a set of by-laws so that there is no ambiguity that would interfere with the disposition and re-purposing of contributed assets. Such a contract can mirror other management contracts that the pension fund may use to engage other asset managers. By structuring the COTs as marketable securities, the creditors and pension plans have a liquidity option to monetize their recovery once the assets in the trust are perceived to be growing in value.

Above all else, the LOT Manager's reputation and integrity must be of the highest caliber and beyond reproach. From the selection process to the continuing oversight of the LOT Manager, there has to be transparency of behavior that is consistent with other pension asset manager protocols.

Oversight of the LOT Manager will likely vary from government to government. A Board of Trustees providing oversight is one approach; Board members might include representatives of the beneficiary pension & OPEB funds, members of the business community, and labor.

In Connecticut, the single fiduciary role of the State Treasurer would compel that office's direct oversight of the LOT Manager.

New value creation is the ultimate measure of success and, consistent with the effort to align incentives, should be tied to the LOT Manager's compensation. While compensation design has

not yet been fully developed, a combination of fees and a small percentage of COTs could be granted to the LOT Manager. The COTs could be restricted: some would be earned over time and some earned based on valuation enhancement performance. Growing LOT asset value further offsets unfunded pension liability, minimizes “catch-up” payments, and stimulates the economy.

### **PRIOR EXAMPLES OF IN-KIND CONTRIBUTIONS**

*The LOT concept is a new idea that has not been previously implemented in the U.S.* In-kind contributions, however, to satisfy legacy obligations like bond indebtedness and pensions have, however, been utilized in the U.S. and internationally. Four examples include:

- **City of Detroit** - The use of real assets as a form of payment was the key to settling the City of Detroit’s Chapter 9 bankruptcy in 2013-2014. Several European banks had financed a \$1.4 billion contribution to Detroit’s grossly underfunded pension; these creditors accepted the transfer of certain valuable real estate along Detroit’s waterfront and downtown area, including the Joe Louis Arena and the Detroit Windsor Tunnel. As the new owners of City assets, these creditors’ long-term recovery became dependent on their willingness to invest new money to maximize the economic value of their assets. Presiding bankruptcy court Judge Steven Rhodes specifically cited this creative alignment of the City’s redevelopment with creditor recovery as an important feature of the City’s successful exit from bankruptcy.
- **City of Hartford** - In 2017, the City of Hartford received a \$5 million credit against its pension liability when it transferred the title of Batterson Park to the City’s pension fund. This action helped the City narrow its cash budget deficit and demonstrates that an in-kind contribution of real assets can successfully be used to offset pension liability.
- **State of New Jersey** - New Jersey’s 2017 transfer of its lottery to the State’s pension system was nationally recognized as an in-kind asset contribution that dedicated a substantial revenue stream to satisfying pension obligations. This transfer, however, took that same revenue stream away from the state’s general fund budget that was otherwise funding education and senior citizen-oriented programs. The bond rating agencies generally regarded this particular move as either “credit neutral” or slightly “credit positive”.
- **Queensland Australia** - Australia’s third largest state, Queensland, experienced a fiscal budget deficit in 2009 in the wake of the global recession. Rating agency downgrades followed rising deficits that ultimately prompted Queensland to announce it would seek

to sell or lease major government-owned assets in response to the crisis. After strenuous public objection to the outright privatization of assets, Queensland contributed the state-owned Queensland Motorways Ltd., a 70-kilometer state-owned toll road, to the pension fund. Queensland received an AU\$3 billion credit against its underfunded pension. The pension fund hired professional infrastructure managers who improved operations and expanded the toll road. In less than five years, the pension sold the toll road to the private sector for AU\$7 billion. In short, Queensland unlocked AU\$7 billion of hidden equity value sitting on its balance sheet for the benefit of the pensions.

It is also noteworthy that the State of New Jersey recently issued a Request for Qualifications to select a professional advisor to assist the State select and develop strategies to maximize the value of State-owned assets to fund the State's pension plans, other post-employment benefit obligations, and existing bonds that collectively exceed more than \$200 billion in obligations. The advisor will evaluate various State assets, including real property, buildings, roads, transit facilities, rights of way, air rights, development rights, naming rights, and infrastructure such as airports, bridges, water facilities, ports, parks and recreational facilities. New Jersey is seeking to complete this evaluation in six months.

In addition, Illinois' Governor J.B. Pritzker recently announced the formation of a pension task force that will evaluate the potential to make in-kind contributions of state-owned capital assets to fund the state's outstanding \$134 billion of unfunded pension liabilities.

### **LOT BENEFITS**

The intended benefits of the LOT structure for a government unit includes:

- an immediate reduction in the Actuarially Determined Employer Contribution ("ADEC", formerly referred to as Annually Required Contribution or "ARC") based on the fair market valuation of the assets contributed to the trust;
- the ADEC reduction has affords the government unit the opportunity to reduce its general fund budget expenditure;
- the contributed assets can potentially be returned to the property tax rolls as they become economically productive;
- an alignment of economic interests of the government unit, labor unions, the business community, and ultimately, the taxpayers

On the expectation that asset values grow, governments will recognize that the upside valuation makes a dent in the unfunded liabilities and can have a positive cashflow impact. As such, the government will have an incentive to create a business and regulatory environment that can further drive asset value.

### **CONCERNS AND VULNERABILITIES**

As noted earlier, the LOT construct has not been fully implemented previously and represents a new approach that will likely go through trial and error and be modified to suit each government.

S&P Global Market Intelligence released a short advisory on February 19, 2019 entitled "Pension Brief: Are Asset Transfers A Gimmick Or A Sound Fiscal Strategy? In this advisory, S&P expresses concern for weak investment returns, demographic challenges, and the potential for economic decline increasing the longer the current expansion lasts. They acknowledge that some state and local governments "have looked to develop creative solutions to help mitigate expanding liabilities and bolster wanting asset levels... they are considering asset transfers along with other revenue streams that can be use to both improve pension funding levels and provide budgetary relief."

S&P has four key questions in considering an asset transfer's impact on credit quality:

- 1) Is the valuation of the asset reasonable and verifiable?
- 2) Is liquidation of the asset practical?
- 3) Does the plan have such a low funded status that liquidity issues may arise prior to the realization of a future revenue stream?
- 4) Is the asset valuation technique an attempt to reduce contribution requirements in the short term while further underfunding the pension system and compounding future contribution requirements?

These are excellent questions and begs additional thoughts on the LOT design considerations.

- 1) *Reasonable and Verifiable Valuation:* an independent valuation at the initial transfer and then regularly afterwards will be required to satisfy S&P's concern. The valuation process should be done by one or more independent professional firms with expertise in the particular assets. Under the LOT design, there would need to be two valuations: one for the assets and a second for the Certificates of Trust. If the LOT development progresses to the point where cash dividends are being paid, a viable secondary market may develop for the COT holders and a true market price could be used to value the COTs.

Such a design could satisfy S&P's concern.

- 2) *Asset Liquidation Practicality*: This concern is addressed as part of the asset selection criteria before the transfer. An asset like a lottery cannot be sold to a private third party; therefore, there should be confidence that the cash generating capacity is steady and reliable. Like New Jersey, a lottery could be transferred directly to the pension but not the LOT construct. The LOT, by design, should have the authority to sell its assets to third parties under the terms and conditions outlined in the LOT Manager's contract.

S&P's concern has additional implications whether assets should be contributed directly to the pension or to an independent vehicle like the LOT. The answer may vary with the type of asset contributed.

Developed enterprise assets, especially those that have tax-exempt debt attached, may best be contributed directly to State pensions in order to avoid triggering refinancing requirements. These assets are likely to be cash-generating enterprises and authority-owned assets that may continue to provide a public benefit while under pension fund ownership. Undeveloped assets may best be suited for contribution to an independent vehicle that is under professional management to maximize value under a highest and best use strategy.

- 3) *Pension Funding Status*: The pension fund liquidity management is a serious concern and requires careful coordination during the asset selection process. A government pension must assume that undeveloped assets contributed to a LOT may require five to eight years of management before it throws off a positive cashflow. Contributing a balance of cashflowing and non-cashflowing assets to a LOT can help abate S&P's concern. In addition, the government could enhance pension liquidity by funding ADEC plus a supplement cash contribution. State Treasurer Denise Nappier raised this very issue was raised during the course of the Commission's deliberations. Treasurer Nappier further expressed concerns about whether such asset transfers may jeopardize attached tax exemption. In addition, the LOT management construct could hinder or conflict with the State Treasurer's fiduciary duty
- 4) *Funding Discipline*: This last S&P concern is perhaps the most compelling. The government unit needs to exercise the necessary fiscal discipline not to underfund in the future if they are going to pursue an in-kind asset contribution strategy. In the absence of such discipline, the asset transfer would be regarded as a "one-shot" gimmick that defers meaningful reform. The LOT concept holds the potential to make a significant dent in legacy obligations but is not the definitive answer to pension and OPEB underfunding. True pension reform



must include the elimination of pension spiking, adjustment of employee contributions, elimination of structural budget deficits, establishment of “rainy day” budget reserves, and re-setting the discount rate.

[NEED DISCUSSION ON ACCOUNTING VS. ACTUARIAL CONSIDERATIONS RE: LOT MANAGEMENT]

#### **NEXT STEPS TO PURSUE FEASIBILITY**

[TO FOLLOW IN NEXT DRAFT]